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No. 87-1377

In the Supreme Court of the United States

OCTOBER TERM, 1987

CHURCH OF SCIENTOLOGY OF CALIFORNIA, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioner satisfied the statutory qualifications for a tax exemption under Section 501(c)(3) of the Internal Revenue Code for tax years 1970-1972.

2. Whether the denial of a tax exemption to petitioner for failure to meet the statutory requirements violated the First Amendment.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 823 F.2d 1310. The opinion of the Tax Court (Pet. App. B1-B146) is reported at 83 T.C. 381.

JURISDICTION

The judgment of the court of appeals (Pet. App. D1) was entered on July 28, 1987. A petition for rehearing was denied on October 19, 1987 (Pet. App. C1). On December 31, 1987, Justice O'Connor extended the time to file a petition for a writ of certiorari to and including February 16, 1988, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. Petitioner was organized in 1954 to propagate Scientology, a religion founded by L. Ron Hubbard. During the tax years at issue here, 1970-1972, it was the "Mother Church" of all Churches of Scientology in the United States. Scientologists believe that they can progress toward spiritual awareness through "auditing." Auditing is administered in private sessions by a trained Scientologist who asks questions of the auditee and measures the latter's skin responses with an electronic device (an "E-meter"), which Hubbard invented and patented. Petitioner charges a "fixed donation" for auditing, which is almost never waived. Pet. App. A4-A6, B35. Petitioner also sells taped lectures and books about Scientology, many of them authored and copyrighted by Hubbard (*id.* at B38-B39).

One of petitioner's official policies, as articulated in a directive carrying Hubbard's imprimatur, is to "MAKE MONEY" (Pet. App. A8, B21, B42). Petitioner sets the prices for its goods and services so as to return a substantial profit (*id.* at B38-B39, B95-B100). Its staff is instructed that "[a]nyone covertly reducing prices" will be treated as if "guilty of a * * * high crime" (*id.* at B36 n.21). Petitioner engages in aggressive promotions, including market surveys and advertisements, and its staff is versed in salesmanship (*id.* at A8, B37-B38). During 1970-1972, its operations were quite lucrative overall, enabling it to build and maintain "massive" cash reserves. Its net income for that period aggregated at least $4 million. *Id.* at B108-B110.

b. Before and during 1970-1972, Hubbard exerted significant control over petitioner's management, financial affairs, and many other facets of its operations (Pet. App. A8, B9). His wife Mary Sue Hubbard held one of its highest executive offices during that period (*id.* at B11).

The Hubbards received salaries from petitioner and one of its affiliates aggregating $20,249 in 1970, $49,648 in 1971, and $115,680 in 1972 (*id.* at A9, B47-B48). Hubbard also received royalties from petitioner, including $10,649 in 1971 and $104,618 in 1972, for sales of his books, taped lectures, and E-meters (*id.* at A9, B48). In addition, petitioner paid the living expenses of the Hubbards and of their four children while on board the *Apollo*, a yacht that cruised the Mediterranean Sea and served as headquarters for one of petitioner's divisions (*id.* at A7, A9, B48). Hubbard also received, before and during 1970-1972, substantial sums from petitioner and from other Scientology organizations around the world as "debt repayments." These payments were designed to compensate him for originating and developing Scientology and for allowing Scientology organizations to use his name, an asset claimed to be worth "millions in goodwill and high credit rating." The payments equalled a percentage, usually ten percent, of the gross income of petitioner and of the other payors. *Id.* at A9-A10, B49, B115-B119.

Between 1971 and 1972, more than $3.5 million of petitioner's cash reserves was deposited in Swiss bank accounts in the name of Operation Transport Corp., Ltd., which was a for-profit "sham" corporation (Pet. App. B19) organized and controlled by the Hubbards. In 1972, at Mr. Hubbard's direction, about $2 million in cash was removed from those accounts and transferred to the *Apollo* where it was stored in a locked file cabinet to which Mrs. Hubbard had the only keys. Other reserves of petitioner were kept in Swiss bank accounts in the name of the United States Churches of Scientology Trust, of which Mr. Hubbard was the sole trustee. The trust was supposed to be for the "defense of Scientology," but less than $10,000 of its funds was expended for that purpose. The Hubbards were signatories of the trust accounts, and Mr. Hubbard kept the trust checkbooks. In 1972, about $1.1 million was withdrawn from the trust accounts, brought

aboard the *Apollo*, and placed in the file cabinet to which Mrs. Hubbard had the only keys. *Id.* at A10, B19-B20, B45-B46.

2. The Commissioner in 1957 recognized petitioner as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code.[1] The Commissioner revoked that status in 1967, finding that petitioner was engaged in business for profit, was operated in a manner whereby a portion of its earnings inured to the benefit of private individuals, and was serving a private rather than a public interest, and therefore that petitioner did not satisfy the statutory requirements for a Section 501(c)(3) tax exemption. The Church, however, did not file income tax returns for the years 1970-1972. After audit, the Commissioner asserted income tax deficiencies totalling $1.15 million for those years and a late filing penalty equal to 25% of the deficiency. Pet. App. A4-A5.

Petitioner brought this suit in the Tax Court for review of the Commissioner's determinations. After a lengthy trial, the Tax Court sustained the Commissioner (Pet. App. B1-B146). The court held that petitioner failed to qualify as an exempt organization for 1970-1972 on three grounds: (1) petitioner operated for a commercial purpose (*id.* at B93-B110); (2) petitioner's net earnings inured to the benefit of the Hubbards (*id.* at B111-B122); and (3) petitioner violated public policy by conspiring to impede the collection of its taxes (*id.* at B122-B129). In finding that petitioner "was operated for the private benefit of L. Ron Hubbard and his family" (*id.* at B122), the court identified "overt" and "covert" elements of inurement. The overt elements included the salaries, living expenses, and royalties paid to the Hubbards. The court found that the

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended.

royalty arrangement reflected "a flagrant case of self-dealing" whereby Hubbard used petitioner for "pushing the sales" of his own works (*id.* at B113). The covert elements included the "debt repayments" to Hubbard and the Hubbards' "unfettered" control over petitioner's large cash reserves. The court found the debt repayments to be little different in substance from "a franchise network for private profit" (*id.* at B116 (internal quotation omitted)). The court stated that the Hubbards' complete control of petitioner's reserves, coupled with their dominance over its affairs, imposed a heavy burden on petitioner to disprove that its funds inured to their private benefit. The court concluded that petitioner had failed to carry that burden, observing that several key Scientology officials, including the Hubbards, had not testified, that the testimony of those witnesses who did testify for petitioner lacked credibility, and that petitioner's documentary proof was scanty. *Id.* at B119-B122, B132-B133.

The Tax Court also rejected petitioner's constitutional claims (Pet. App. B67-B88). The court held that Section 501(c)(3), on its face and as applied in this case, is consistent with petitioner's rights under the Free Exercise Clause (Pet. App. B75-B80). The court also held that the statute satisfies the Establishment Clause because it does not favor one religion over another (*id.* at B80-B81) or create an impermissible entanglement with religion (*id.* at B81-B85). The court also ruled that petitioner has not shown that it was victimized by selective enforcement of the tax laws in connection with the revocation of its exemption (*id.* at B67-B74).

3. The court of appeals affirmed (Pet. App. A1-A25). The court ruled that petitioner was not entitled to exempt status for the years at issue because it failed to establish that no part of its net earnings inured to private in-

dividuals within the meaning of Section 501(c)(3) (Pet. App. A10-A20).[2] The court agreed with the Tax Court that the royalty payments to Hubbard "cross[ed] the line between reasonable and excessive," thereby supporting a finding of inurement (*id.* at A16). The court also agreed with the finding that Hubbard "had unfettered control over millions of dollars in Church assets" (*ibid.*). Like the Tax Court, the court of appeals concluded that petitioner had failed to carry its burden of proving that the enormous amounts of money within Hubbard's control did not inure to his personal benefit (*id.* at A16-A18). Finally, the court of appeals concurred in the Tax Court's finding that a percentage of the gross income of petitioner and of other Scientology organizations inured to Hubbard's benefit as "debt repayments" throughout the years in issue (*id.* at A18-A20). The court concluded that "the cumulative effect of Hubbard's use of the Church to promote royalty income, Hubbard's unfettered control over millions of dollars of church assets, and his receipt of untold thousands of dollars worth of 'debt repayments' strongly demonstrate inurement" (*id.* at A20).[3]

ARGUMENT

The courts below correctly upheld the revocation of petitioner's tax exemption, and the decision below does

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[2] The court of appeals did not reach the other bases upon which the Tax Court's decision rested, *i.e.*, that petitioner operated for a commercial purpose and that its operation violated public policy.

[3] The court also rejected, as had the Tax Court, petitioner's argument that the audit and revocation of its exempt status reflected selective prosecution by the Commissioner based on hostility to petitioner's religion (Pet. App. A20-A23). In the court's view, the Commissioner's decision to revoke the exemption was based on "legitimate agency concerns" and on "exhaustive and responsible investigation" (*id.* at A21, A23).

not conflict with any decision of this Court or of another court of appeals. Moreover, the thrust of petitioner's contentions—that it is entitled to a new trial (see Pet. 28) because the evidence in this record relied upon by the court of appeals is insufficient to support the finding that a portion of petitioner's income inured to the Hubbards during the years at issue—presents a factbound question of limited effect[4] that does not warrant the attention of this Court.

1. The courts below correctly found that petitioner did not qualify for a Section 501(c)(3) tax exemption during 1970-1972 because a portion of its income inured to the Hubbards during those years. The anti-inurement restriction reflects the underlying policy of Section 501(c)(3) that the tax exemption be available only to organizations dedicated to public, rather than private, ends. The targets of the restriction are the various devices that founders and other insiders "having a personal and private interest in the activities of the organization" (Treas. Reg. § 1.501(a)-1(c)) may use to divert the profits of the organization for their personal gain—such as excessive salaries, property transfers that are not made at arm's-length, and commingling of assets.

The courts have consistently sustained the Commissioner's finding of prohibited inurement when such devices have enabled private persons to use organizational funds to enrich themselves. See, *e.g, Harding Hospital, Inc.* v. *United States,* 505 F.2d 1068 (6th Cir. 1974); *Kenner* v. *Commissioner,* 318 F.2d 632 (7th Cir. 1963); *Birmingham Business College* v. *Commissioner,* 276 F.2d 476 (5th Cir. 1960); cf. *Parker* v. *Commissioner,* 365 F.2d 792 (8th Cir.

[4] Although petitioner's tax-exempt status was revoked in 1967, the decision below applies only to the tax years involved, 1970-1972. L. Ron Hubbard, the primary beneficiary of the inurement found by the courts below in the years at issue, died in 1986. The decision below does not control the tax-exempt status of other branches of the Church of Scientology for any years.

1966), cert. denied, 385 U.S. 1026 (1967) (income of religious organization attributed to founder who exercised unfettered control over its activities and commingled its funds with his own). See generally 4 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 100.2.4 (1981). In a case closely analogous to this one, the Court of Claims denied Section 501(c)(3) treatment to another branch of the Church of Scientology for three taxable years in the 1950s on the ground that its net income inured to the private benefit of the Hubbard family. *Founding Church of Scientology* v. *United States,* 412 F.2d 1197 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970). The court found unlawful inurement in the form of salaries, commissions, and reimbursements unsupported by evidence of reasonableness, combined with loans for unexplained purposes, inflated rentals, and other questionable payments. The court there concluded that Hubbard, found to be "the dominant figure in Scientology" (412 F.2d at 1201), and his family were "entitled to make ready personal use of the corporate earnings" (*id.* at 1202).

The decision below is fully consistent with the principles applied in these cases. The court found that Hubbard exploited petitioner to market his works, from which he derived excessive royalties; that he received an indeterminate share of petitioner's gross receipts and those of other Scientology organizations in the guise of "debt repayments"; and that he channeled millions of dollars of petitioner's cash reserves through "a bogus trust fund and a sham corporation" (Pet. App. B86) until the money came to rest on the yacht on which he resided – in a locked cabinet to which his wife had the only key (*id.* at B112-B122). In these circumstances, the court found that petitioner did not carry its burden of establishing that the Hubbards, who indisputably had "a personal and private

interest in the activities of the organization" (Treas. Reg. § 1.501(a)-1(c)), did not divert a portion of the organization's earnings to their personal benefit. Indeed, in light of petitioner's failure to produce evidence from the persons who had direct knowledge of the transactions in question, the court concluded that there was "an overwhelming failure of proof" by petitioner (Pet. App. B122). The court of appeals examined the record and sustained the Tax Court's findings of fact, concluding that the evidence "strongly demonstrate[s] inurement" (*id.* at A20). There is no reason here for this Court to depart from its usual practice of declining to review the concurrent findings of fact of two lower courts. See, *e.g.*, *Berenyi* v. *Immigration Director*, 385 U.S. 630, 635-636 (1967).

2. Petitioner also argues that the revocation of its tax exemption violates the First Amendment. Petitioner contends (Pet. 12-18) that the anti-inurement condition of Section 501(c)(3), to the extent that it authorizes denial of an exemption for excessive royalty payments, unconstitutionally discriminates against "newer" religious groups that must proselytize aggressively in order to attract a following. Thus, petitioner suggests that the decision below will chill other religions from aggressively promoting their message. This contention is without merit. The anti-inurement restriction has a neutral, secular basis in charitable trust law, which requires qualifying organizations to operate primarily for the benefit of the public, rather than for commercial purposes or private gain. See *Bob Jones University* v. *United States*, 461 U.S. 574 (1983). It does not penalize aggressive promotion of religion; it does, however, prohibit "flagrant * * * self-dealing" in the form of a person's using a tax-exempt organization that he controls for the purpose of "market[ing] his own works" for personal gain (Pet. App. B113). There is simply no basis for concluding that the

application of Section 501(c)(3) here, or the statute on its face, reflects any unconstitutional discrimination among religions.

Petitioner also suggests (Pet. 22-25) that enforcement of the anti-inurement restriction requires excessive entanglement with religion. This suggestion is clearly mistaken. The inquiry into whether the founder of a religion or another insider has appropriated its profits for his personal use does not intrude into church dogma or belief. The courts correctly held in this case that there was no unconstitutional scrutiny of the religious content of petitioner's activities,[5] or any other basis for finding a First Amendment violation (Pet. App. A20-A23, B74-B85).[6]

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[5] The Tax Court did note that the Commissioner's audit was made more difficult by petitioner's dilatory tactics and misrepresentations (Pet. App. B49-B60, B124-B126). Thus, the court found in response to petitioner's complaints about the intrusiveness of the audit that "the blame for a goodly measure of this involvement must be laid at petitioner's doorstep" (*id.* at B84).

[6] The question whether petitioner qualified as a tax-exempt organization for the years 1970-1972 is distinct from the question whether payments by individuals to petitioner or other branches of the Church of Scientology for auditing and training are tax-deductible contributions when made to exempt organizations. Accordingly, there is no reason to hold this case pending the disposition of the petitions for certiorari in *Hernandez* v. *Commissioner*, No. 87-963, *Commissioner* v. *Staples*, No. 87-1382, *Miller* v. *Commissioner*, No. 87-1449, and *Graham* v. *Commissioner*, No. 87-1616.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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